PETITION AND TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, [redacted] 1926

No. [redacted] 289

THE UNITED STATES, PETITIONER

vs.

CHARLES A. LUDEY

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED FEBRUARY 4, 1926
CERTIORARI GRANTED APRIL 19, 1926

(31676)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1925

No. 953

THE UNITED STATES, PETITIONER

vs.

CHARLES A. LUDEY

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

INDEX

95142—26——1

A In the Supreme Court of the United States

October term, 1925

No. ——

United States of America, petitioner

v.

Charles A. Ludey

Petition for writ of certiorari to the United States Court of Claims

The United States of America prays that a writ of certiorari issue to the United States Court of Claims directing that court to certify to this court the record in the case of Charles A. Ludey v. The United States, No. D-360 in that court, in order that the decision and judgment of said court, rendered on November 9, 1925, may be reviewed.

STATEMENT OF THE CASE

This suit was to recover taxes paid under protest, and claimed to have been illegally assessed, and claim for refund of which had been denied.

B The findings of the Court of Claims show that Charles A. Ludey filed a return of his income for the calendar year 1917. In this return he claimed as a deduction from gross income an alleged loss upon the sale of certain oil properties, some of which were acquired before and some after March 1, 1913. The claimant contended in his petition that the loss was more than that claimed in his return, namely, $14,777.33. The Commissioner of Internal Revenue found that claimant derived a taxable profit of $26,904.15 on such sales.

The sale out of which the commissioner held that a gain arose was of certain oil property designated in the pleadings as:

(1) The Goodman fee and Matney lease,
(2) The Wolf lease,
(3) The Billingslea lease,
(4) The Pittman fee, and
(5) The Helphrey oil drilling rig.

Item No. 1, the Goodman fee and the Matney lease were purchased prior to March 1, 1913, at $20,000. They were worth on March 1, 1913, $47,500, and between March 1, 1913, and the date of sale equipment and improvements had been added at a cost of $6,000. The remaining property, items Nos. 2, 3, 4, and 5 were acquired after March 1, 1913, at a total cost, including subsequent improvements, of $42,477.33. The entire property was sold in 1917

C for $81,200. Between March 1, 1913, and the date of sale these properties had been operated by the claimant and certain oil had been extracted. The value of the oil thus extracted was $32,253.81. During the same period the equipment had been used by the claimant and had depreciated by wear and tear to the

extent of $10,465.16. In calculating the gain derived from this transaction the commissioner determined that the decrease by reason of the depletion of the oil reserves and the depreciation from wear and tear should be deducted from the cost of the property sold before determining whether there was a gain. The claimant in arriving at a loss from this transaction deducts nothing for the depletion of the oil reserves and nothing for the wear and tear of the equipment.

The Court of Claims held that the Government's depletion and depreciation adjustments on sale of property in 1917 were erroneous.

THE STATUTES

Title I, act of September 8, 1916 (chap. 463, 39 Stat. 756), as amended by the act of October 3, 1917 (chap. 63, 40 Stat. 300, 329), provides:

"SEC. 1. (a) That there shall be levied, assessed, collected, and paid anually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *.

D "(b) In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a nonresident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceed $20,000 and does not exceed $40,000 * * *.

"(c) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.

"SEC. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in
E whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * * * *

"(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen

hundred and thirteen, shall be the basis for determining the amount of such gain derived.

"SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

"(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * * *

"Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not com-
F pensated for by insurance or otherwise: Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

"Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *.

"SEC. 1. WAR INCOME TAX (chap. 63, 40 Stat. 300).—That in addition to the normal tax imposed by subdivision (a) of section one of the act entitled 'An act to increase the revenue, and for other purposes,' approved September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like normal tax of two per centum upon the income of every individual, a
G citizen or resident of the United States received in the calendar year nineteen hundred and seventeen and every calendar year thereafter.

"SEC. 2. WAR INCOME TAX.—That in addition to the additional tax imposed by subdivision (b) of section one of such Act of September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like additional tax upon the income of every individual received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, as follows:

"One per centum per annum upon the amount by which the total net income exceeds $5,000 and does not exceed $7,500 * * *."

Title II, act of October 3, 1917 (chap. 63, 40 Stat. 303), provides:

"SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, part-
H nership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

"Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year * * *."

THE ISSUES

I. In computing the gain derived from a sale of capital assets does the revenue act of 1916, as amended by the revenue act of 1917, require that the cost or the March 1, 1913, value be reduced by depletion and depreciation sustained?

II. Where property is acquired prior to March 1, 1913, and the sale price is greater than the cost but less than the March 1, 1913, value, is a loss sustained under the provisions of the revenue act of 1916, as amended by the revenue act of 1917?

I REASONS FOR GRANTING THE PETITION

1. In the view of the petitioner the Court of Claims erred in holding as follows:

(a) That in determining gain or loss of owner or lessee upon the sale of oil rights, depletion sustained or previously allowed for oil extracted may not be subtracted from the cost price in determining gain or loss upon sale in 1917.

(b) That depreciation sustained or previously allowed should not be subtracted from the cost price in determining a gain or loss in 1917.

(c) That, on properties purchased prior to March 1, 1913, no taxable gain or taxable loss resulted where the selling price in 1917 was less than the March 1, 1913, value thereof, but was greater than the cost.

(d) That as to properties purchased subsequent to March 1, 1913, the facts show a loss thereon.

2. The determination of the questions involved herein vitally affects the rules followed by the Internal Revenue Bureau since the inception of income taxation. The decision of the Court of Claims is antagonistic to these rules, which have been generally acquiesced in by taxpayers. A change in the rules at this time would affect all years previous to the effective date of the revenue act of 1924, which makes specific provision for such cases. An ascertainment of the amount of taxes in other cases dependent upon the correctness of the Government's position is not possible, but, without question, it runs into many millions of dollars.

The rule followed by the Government has been approved by the Board of Tax Appeals. (Even Realty Company, 1 B. T. A. 355.)

Wherefore it is respectfully submitted that this petition for writ of certiorari to review the judgment of the United States Court of Claims should be granted.

William D. Mitchell,
Solicitor General.

Herman J. Galloway,
Assistant Attorney General.

Fred K. Dyar,
Special Assistant to the Attorney General.

January, 1926.

1 In Court of Claims of the United States of America

CHARLES A. LUDEY, *against* THE UNITED STATES OF AMERICA.	D-360

I. *Petition*

Filed June 5, 1924

To the Court of Claims of the United States and to the Honorable the Judges Thereof:

The above named claimant, by Johnson & Shores, his attorneys, by this his petition respectfully shows:

1. The claimant at all times hereinafter mentioned was and is a citizen of the United States and a resident of the city of Parkersburg, county of Wood, State of West Virginia.

2. The claimant has a just claim for the refund of $11,715.45 paid by him to the collector of internal revenue for the district of Oklahoma as income and excess profits taxes wrongfully assessed by the Commissioner of Internal Revenue of the United States for the taxable year ending December 31, 1917, with interest thereon.

The provisions of law under which such taxes were wrongfully assessed and collected and upon which the claimant claims
2 such refund are sections 1, 2, and 5 of Title I of the revenue act of September 8, 1916, as amended by the revenue act of October 3, 1917, and section 201 of Title II of the revenue act of October 3, 1917.

3. Pursuant to section 3173 of the Revised Statutes and other acts of Congress provided, the claimant on or about March 23, 1918, on official Forms No. 1040 and No. 1101, made to the Commissioner of Internal Revenue his income and excess profits tax returns for the taxable year ending December 31, 1917, for the taxes imposed by said sections 1, 2, 5, and 201. In said income tax return claimant's net taxable income for the taxable year ending December 31, 1917, was stated to be $30,594.33.

4. Upon said income tax return income taxes in the sum of $2,110.15 were assessed against claimant on or about June 1, 1918. The claimant duly paid to the collector of internal revenue for the district of Oklahoma the said sum of $2,110.15 on or about June 15, 1918.

5. In determining his net taxable income reported in said returns for 1917 the claimant deducted $7,621.33 as a loss sustained upon the sales by claimant in February, 1917, of certain oil lands, leases and properties, to wit: the fee to Goodman farm, a lease to Matney farm, a lease to Wolfe farm, a lease to Billingslea farm, the fee to Pitman farm, and a one-third interest in Helphrey oil drilling rig.

The said Goodman fee and Matney lease were purchased by claimant in 1911 at an aggregate purchase price of $20,000 and had on

March 1, 1913, an aggregate fair market value, with physical equipment, of $47,500, of which $39,500 was the value of oil reserves and $8,000 the value of physical equipment. Subsequent to March
3 1, 1913, there were added by claimant to said Goodman farm equipment and improvements at a cost of $6,000.

The said Wolfe lease was purchased by claimant in July, 1913, for $26,500.00, of which $17,500 was paid for oil reserves and $9,000 for physical equipment, and thereafter equipment and improvements were added thereto by claimant at a cost of $1,794.00.

The said Billingslea lease was purchased by claimant in December, 1913, for $11,000, of which $5,000 was the value of the oil reserves and $6,000 the value of the physical equipment.

The said Goodman fee, Matney lease, Wolfe lease, and Billingslea lease were sold by claimant in February, 1917, for an aggregate sales price of $76,500.

The said Pitman fee was purchased by claimant in February, 1915, for $3,000 and was sold by claimant in 1917 for $4,500.

The said one-third interest in Helphrey oil drilling rig was purchased by claimant in 1916 for $183.33 and was sold by claimant in 1917 for $200.

Computed in accordance with the provisions of said revenue act of 1916, claimant sustained a loss of $14,777.33 on said sales, wherefore claimant's net taxable income for the taxable year ending December 31, 1917, amounted to $23,438.33, and the income and excess profits taxes lawfully assessable on said returns amounted to $1,251.36.

6. By letter dated January 16, 1923, the Commissioner of Internal Revenue notified the claimant that an additional assessment of income and excess profits taxes amounting to $10,856.66 would be listed against the claimant for the taxable year ending December 31, 1917.

4 7. Following such notice, and on November 5, 1923, the collector of internal revenue for the district of Oklahoma made unlawful demand upon claimant for the payment of $10,856.66 as additional income and excess profits taxes for the taxable year ending December 31, 1917, determined as described in the letter of the Commissioner of Internal Revenue, dated January 16, 1923, referred to in paragraph 6 hereof.

8. On November 9, 1923, the claimant under the threat of said collector of penalties if claimant failed to make such payments, and in the belief that such threat would be carried out, paid to the said collector at Oklahoma City, Oklahoma, the said sum of $10,856.66. The said payment was made under duress and protest, and at the time of making such payment the claimant filed with the said collector a written protest against such additional assessment and against the enforced payment thereof. A copy of such protest, marked "Exhibit A," is attached hereto and made a part hereof.

9. On information and belief the claimant avers that the sum of $12,966.81 so paid by claimant to the said collector was there-

after by the said collector turned over and deposited into the Treasury of the United States of America as in the usual course of his official business.

10. On November 12, 1923, pursuant to section 3220 of Revised Statutes, and other acts of Congress provided, the claimant duly filed with the said collector a claim for refund of $10,856.66 or such greater amount as was legally refundable. A copy of said claim for refund, hereto attached and marked "Exhibit B," is made a part of this petition.

5 The taxes, refund of which was so claimed, resulted from the unlawful rejection and disallowance by the Commissioner of Internal Revenue of $14,777.33, the loss sustained by claimant on the sale of the oil properties above described, and from the erroneous finding by the Commissioner of Internal Revenue that claimant sustained no loss, but derived a profit of $26,904.15 from the sale of said oil properties.

11. On March 20, 1924, claimant's said claim for refund was rejected by the Commissioner of Internal Revenue, and the sum of $11,715.45 is now wrongfully and unlawfully retained and withheld from the claimant without his consent and against his will by the United States of America.

12. No other action than as aforesaid has been had on this claim in Congress or in any of the departments. The claimant has at all times borne true allegiance to the Government of the United States. He has not in any way voluntarily aided, abetted, or given encouragement to rebellion against such Government. He is and always has been the sole and absolute owner of the claim here presented. He has made no transfer or assignment of said claim or of any part thereof, or of any interest therein. He is justly entitled to the amount claimed from the United States of America, after allowing all just credits and offsets.

13. Claimant believes the facts as herein stated to be true.

Wherefore the claimant prays for judgment against the United States of America upon the facts and the law for $11,715.45, together with interest on $858.79 from June 15, 1918, and
6 interest on $10,856.66 from November 9, 1923, and his reasonable costs and disbursements herein.

CHARLES A. LUDEY, *Claimant.*
JOHNSON & SHORES,
By WAYNE JOHNSON,
Member of Firm.
JOHNSON & SHORES,
Attorneys for Claimant,
Office & P. O. Address, 100 Broadway,
Borough of Manhattan, City and State of New York.

[*Duly sworn to by Charles A. Ludey; jurat omitted in printing.*]

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7 *Exhibit A to petition*

PROTEST

This payment is made under duress and compulsion of threatened distraint and penalties, solely to avoid such distraint and penalties and under specific protest that the tax demanded is illegal and not computed in accordance with law. I specifically protest that the tax is illegal in the following particulars:

The Bureau of Internal Revenue has computed the profit resulting from the sale of my oil properties by reducing the cost and March 1, 1913, value thereof by the depletion sustained prior to the date of such sale and has erroneously treated as profit the difference between such depleted cost and March 1, 1913, value and the total consideration received by me. I contend that in determining the profit from such sale the cost and March 1, 1913, value should not be reduced by the amount of depletion sustained. I further contend that the additional tax is illegal in that the bureau has computed the depletion allowance to me by the unit or present value method, whereas such depletion allowance should be computed according to the actual reduction in flow and production as provided by law.

And I further contend that said additional tax is illegal and not properly assessed for other reasons not here specifically stated.

CHARLES A. LUDEY.

MARIETTA, OHIO, *November 5, 1923.*

8 *Exhibit B to petition*

CLAIM FOR

TREASURY DEPARTMENT.

Internal Revenue Service.
Form 843—Jan., 1922.
Comptroller General, U. S.,
January 18, 1922.

IMPORTANT

File with collector of internal revenue where assessment was made. Not acceptable unless completely filled in.

NOTICE TO COLLECTOR

Collector must indicate in block above the kind of claim, except in income-tax cases.

Abatement of tax assessed
Credit against outstanding assessments
xRefund of taxes illegally collected
Refund of amounts paid for stamps used in error or excess

Date received by Administrative unit

Stamp here

COLLECTOR'S NOTATION

District

Account number

Date received

Stamp here

Collector of internal revenue

STATE OF OHIO,
County of Washington, ss:

CHARLES A. LUDEY
(Name of taxpayer or purchaser of stamps)

PRINT OR TYPE

Marietta, Ohio.
(Residence—give street and number as well as city or town and State)

(Business address)

This deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below with reference to said statement are true and complete:

Period	Year
From January	1, 1917
To December	31, 1917

1. Business in which engaged: Oil operator.
2. Character of assessment or tax: Additional income and profits taxes.

(State for or upon what the tax was assessed or the stamps affixed)

3. Amount of assessment or stamps purchased------- $10,856.66
4. Reduction of tax liability requested (income and profits tax) -- $10,856.66
5. Amount to be abated---------------------------- $--------
6. Amount to be refunded (or such greater amount as is legally refundable)------------------------ $10,856.66

9 7. Dates of payment (see collector's receipts or indorsements of canceled checks), November 9, 1923.

(If statement covers income tax liability, items 8–11, inclusive, must be answered)

8. District in which return (if any) was filed: Oklahoma.
9. District in which unpaid assessment appears: Oklahoma.
10. Amount of overpayment claimed as credit------ $----------
11. Unpaid assessment against which credit is asked; period from ------------------------------------ $----------

Deponent verily believes that this application should be allowed for the following reasons:

The additional assessment is erroneous in that the Bureau of Internal Revenue computed the profit resulting from the sale of deponent's oil properties by reducing the cost and March 1, 1913, value thereof by the depletion sustained prior to the date of such sale and erroneously treated as profit the difference between such depleted cost and March 1, 1913, value and the total consideration received by deponent. Deponent contends that in determining the profit from such sale the cost and March 1, 1913, value should not be reduced by the amount of depletion sustained.

The additional assessment is further erroneous in that the bureau computed the depletion allowance to this taxpayer by the unit or present value method, whereas such depletion allowance should be computed according to the actual reduction in flow and production as provided by law.

(Attach additional sheets if necessary)

(Signed) Charles A. Ludey.

Sworn to and subscribed before me this 10th day of November, 1923.

Ezra Miller, *Notary Public.*
(Title)

(This affidavit may be sworn to before a deputy collector of internal revenue or revenue agent without charge)

10 II. *General traverse*

Aug. 5, 1924

No demurer, plea, answer, counterclaim, set-off, claim of damages, demand, or defense in the premises having been entered on the part of the defendant, a general traverse is entered as provided by rule 34.

III. *History of proceedings*

On February 3, 1925, this case was argued and submitted on merits by Mr. Wayne Johnson, for the plaintiff, and by Mr. Thomas H. Lewis, jr., for the defendant.

On May 11, 1925, the court filed findings of fact, with an opinion by Judge Graham, together with the following order: "It is ordered by the court that this case be and it is remanded for a stipulation or evidence as to the amount of a judgment that should be rendered for the plaintiff under the conclusions stated in the court's opinion."

On June 9, 1925, the claimant filed a motion to amend findings of fact and opinion.

On the same day a stipulation for judgment in compliance with the order of court issued May 11, 1925, was filed.

On Nov. 9, 1925, the court entered the following order:

"Order

It is ordered by the court this 9th day of November, 1925, that the plaintiff's motion to amend findings and opinion be and the same is allowed in part and overruled in part.

The former findings, conclusion of law, and opinion are vacated, set aside, and withdrawn, and amended findings, as special findings of fact, and conclusion of law entering judgment for plaintiff, with opinion, are this day filed.

11 IV. *Special findings of fact, conclusion of law, and opinion of the court, by Graham, J.*

November 9, 1925

This case was originally submitted upon an agreed statement of facts, the stipulation in that regard being signed on behalf of plaintiff by his attorneys and on behalf of defendant by Assistant Attorney General Herman J. Galloway, and upon a supplemental agreed statement of facts filed June 9, 1925, and upon such agreed statements of facts the court makes the following

Special findings of fact

I

Plaintiff is a citizen of the United States and a resident of the city of Parkersburg, county of Wood, State of West Virginia, and

has not in any way aided, abetted, or given encouragement to rebellion against the United States, or at any time aided or abetted in any manner, or given comfort to, any sovereign or government that is or ever has been at war with the United States.

II

Plaintiff on or about March 23, 1918, filed his income and excess-profits tax returns for the taxable year ending December 31, 1917. In said income-tax return plaintiff's net taxable income was stated to be $30,594.33. True copies of said income and excess-profits tax returns are annexed to plaintiff's petition as Exhibits C and D, respectively, and made a part of this finding by reference.

III

On or about June 1, 1918, there were assessed against plaintiff upon his net taxable income shown in said income-tax return income taxes in the sum of $2,110.15, which plaintiff duly paid to the collector of internal revenue for the district of Oklahoma on or about June 15, 1918.

IV

In determining his net taxable income reported in said returns plaintiff deducted $7,621.33 as a loss alleged by plaintiff to have been sustained by him upon his sale in February, 1917, of cer-
12 tain oil lands, leases, and property, to wit, the fee to Goodman farm, a lease to Matney farm, a lease to Wolfe farm, a lease to Billingslea farm, the fee to Pitman farm, and one-third interest in Helphrey oil-drilling rig.

All of said lands and property were located in the county of Tulsa, State of Oklahoma.

The fee to said Goodman farm and said Matney lease were purchased by plaintiff in 1911 at an aggregate price of $20,000, and had on March 1, 1913, an aggregate fair market value, with physical equipment, of $47,500, of which $39,500 was the value of oil reserves and $8,000 the value of the physical equipment. Subsequent to March 1, 1913, there were added by plaintiff to said Goodman farm equipment and improvements at a cost of $6,000.

Said Wolfe lease was purchased by plaintiff in July, 1913, for $26,500, of which $17,500 was paid for oil reserves and $9,000 for physical equipment, and thereafter equipment and improvements were added thereto by plaintiff at a cost of $1,794.

Said Billingslea lease was purchased by plaintiff in December, 1913, for $11,000, of which $5,000 was the value of the oil reserves and $6,000 the value of the physical equipment.

The Pitman fee was purchased by plaintiff in February, 1915, for $3,000, and was sold by him in 1917, for $4,500, a gain of $1,500.

The one-third interest in Helphrey oil-drilling rig was purchased by plaintiff in 1916 for $183.33 and sold by him in February, 1917, for $200, a gain of $16.67.

The Goodman fee, Matney lease, Wolfe lease, and Billingslea lease were sold by plaintiff in February, 1917, for an aggregate price of $76,500. This price was based on the daily production of the four properties, namely, 51 barrels, valuing the properties at $1,500 for each barrel of oil produced daily. The daily production of each of the four properties at the time of sale was as follows:

The Goodman fee, 21.5 barrels; Matney lease, 9.6 barrels; Wolfe lease, 12.5 barrels; and Billingslea lease, 7.4 barrels.

The proportion of the total sales price allocable to the Goodman fee and Matney lease was $46,650. As this was in excess of the cost of these properties but less than their fair market value as of March 1, 1913, there was neither gain nor loss on the sale of these two properties.

The proportion of the total sales price of $76,500 allocable to the sale of the Wolfe lease, the Billingslea lease, and their equipment was $29,850.

As the Wolfe and Billingslea leases and their equipment cost the plaintiff $39,294, these properties were sold at a loss of $9,444.

On the sale of all the properties there was a loss of $7,927.33. Considering this loss, the correct taxable net income of plaintiff for 1917 was $30,288.33, and the correct tax due thereon was $2,073.36. The total tax paid by plaintiff for 1917 was $12,966.81, of which $2,110.15 (an overpayment of $36.79) was paid on June 15, 1918, and $10,856.66 was paid on November 9, 1923. The difference between the total tax paid by plaintiff for 1917, namely, $12,966.81, and the tax due on the basis of the above computation, namely, $2,073.36, is $10,893.45.

The parties stipulated that the amount of the judgment herein, on the basis of the court's conclusion herein, should be $10,893.45,
13 with interest on $36.79 from June 15, 1918, and interest on $10,856.66 from November 9, 1923.

V

Between March 1, 1913, and the date of said sales in February, 1917, depletion was sustained upon said properties in the sum of $32,253.81 and depreciation in the sum of $10,465.16, according to the method of computation employed by the Bureau of Internal Revenue.

The Commissioner of Internal Revenue allowed plaintiff deductions from his income-tax returns for the years 1913, 1914, 1915, and 1916 on account of depletion and depreciation on said properties in the amounts authorized by law and claimed by plaintiff on said returns, in the aggregate sum of $5,156.

VI

By letter dated January 16, 1923, a true copy of which is annexed to plaintiff's petition as Exhibit E, and made a part of this finding by reference, the Commissioner of Internal Revenue notified plaintiff that an additional assessment of income and excess-profits taxes amounting to $10,856.66 would be listed against plaintiff for the taxable year ending December 31, 1917. Thereafter the said sum of $10,856.66 was duly assessed against the plaintiff, the plaintiff having executed a waiver of the limitations upon assessment.

VII

On November 5, 1923, the collector of internal revenue for the district of Oklahoma made demand upon plaintiff for the payment of said $10,856.66 additional income and excess-profits taxes for the year 1917, determined and assessed as aforesaid.

VIII

On November 9, 1923, plaintiff, under threat of said collector of penalties if plaintiff failed to make such payment and in the belief that such threat would be carried out, paid to the said collector at Oklahoma City, Okla., the sum of $10,856.66. At the time of payment plaintiff filed with the said collector a written protest against said additional assessment and against the enforced payment thereof. A true copy of said protest is annexed to the petition herein as Exhibit A, and is by reference made a part of this finding.

IX

On November 12, 1923, plaintiff duly filed with the Treasury Department, through said collector of internal revenue, a claim for refund of $10,856.66, or such greater amount as was legally refundable. A true copy of said claim for refund is annexed to the petition herein as Exhibit B, and is by reference made a part of this finding.

X

On March 20, 1924, said claim for refund was disallowed and rejected by the Commissioner of Internal Revenue.

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XI

The taxes, refund of which was so claimed, disallowed, and rejected and which are sought in this action to be recovered, were paid without protest in the amount of $858.79 on plaintiff's original return, and under protest in the amount of $10,856.66 by reason of

the additional assessment aforesaid and resulted from the rejection and disallowance by the Commissioner of Internal Revenue of a deduction of $14,777.33 claimed by plaintiff as a loss sustained by him on the sales of said oil lands, leases, and property and from the finding by the Commissioner of Internal Revenue that plaintiff sustained no loss, but derived a profit of $26,904.15 from said sales.

Conclusion of law

Upon the foregoing special findings of fact, which are made a part of this judgment, the court decides, as a conclusion of law, that the plaintiff is entitled to recover the sum of $10,893.45, with interest on $36.79 from June 15, 1918, to November 9, 1925, amounting to $16.33 (Finding IV), and on $10,856.66 from November 9, 1923, to November 9, 1925, amounting to $1,302.80, a total of $12,212.58.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of twelve thousand two hundred and twelve dollars and fifty-eight cents ($12,212.58).

Opinion

Graham, Judge, delivered the opinion of the court:

This case comes on to be heard on the joint motion of the attorneys for plaintiff and defendant to amend the findings of fact heretofore made, and a stipulation of additional facts has been filed by said attorneys with the motion to amend.

The case as originally heard was on a stipulation of facts. The court concluded that the plaintiff was entitled to recover in some amount, but was unable to determine from the facts then stipulated what the amount should be, and entered an order remanding the case for a stipulation or evidence as to the amount of the judgment that should be rendered for the plaintiff under the conclusion reached by the court.

This is a suit to recover amounts paid as taxes on income claimed to have been illegally assessed. The plaintiff prior to the year 1917 owned certain oil rights held in fee and by leases, in the operation of which he had been taking out oil. During the said year he sold these rights, some of which had been purchased prior to March 1, 1913, and the others thereafter. In his income-tax return for the year 1917 plaintiff made a deduction from his income for that year for a loss claimed to have been sustained in the sale of these oil rights. The Commissioner of Internal Revenue assessed him on the basis of this return in the amount of $2,110.15, which he paid on June 15, 1918. Thereafter the commissioner notified him of an additional assessment of $10,856.66, which the plaintiff paid under protest on November 9, 1923; and after demand for refund and compliance with the requirements of the statute he brought this suit to recover the said sum of $10,856.66, with interest from

15 November 9, 1923, as well as an additional sum of $858.79, with interest from June 15, 1918, a total sum of $11,718.45.

The claim for recovery of the said sum of $858.79 was based upon an alleged error in the first return of June 15, 1918, due to making too small a deduction for the loss sustained in the sale of the oil rights. The second assessment of $10,856.66 grew out of the following facts: The plaintiff had extracted oil from said properties (from which of them it does not appear) between March 1, 1913, and the date of the sale in February, 1917, on account of which depletion had been sustained in the sum of $32,253.81 and depreciation in the sum of $10,469.16. In his income-tax returns for the years 1913, 1914, 1915, and 1916 the plaintiff had returned the output for each of these years, and deductions, as specially provided by statute, had been allowed him on account of the depletion and depreciation of his properties. The sum named in the second assessment for depletion was based upon the amount of oil which had been taken out and sold by plaintiff after March 1, 1913; the amount for depreciation was the estimated wear and tear on the properties. These sums aggregated $42,718.97, which the Commissioner of Internal Revenue, in making the reassessment, subtracted from the cost price of the properties, and he deducted the remainder thus found from the selling price, which showed an alleged gain of $27,941.64 on the sale of the properties as against the cost price. This alleged gain was added to plaintiff's net income as stated in his first return and the reassessment based upon the sum found by this addition. If the addition of this sum to the net income was not legal, then plaintiff has been illegally assessed for taxes to that extent. This takes us back to the deduction of $42,718.97 from the cost price for depletion and depreciation.

As stated above, the claim for depletion was based upon the amount of oil taken out of the properties and sold after March 1, 1913; the sum for depreciation was the estimated wear and tear on the properties. We will consider first the question of depletion.

Some confusion has arisen in the case owing to an erroneous view of the character of the property rights of the plaintiff. These were oil rights. By them plaintiff secured the right to extract oil from these different pieces of land. The amount of oil which each contained was not known to the plaintiff or anyone. He had a mere right to extract whatever oil he could, be that amount small or great. He might take a certain amount out and then dispose of the property, but when he sold these rights he sold the same thing that he bought—a mere right to extract oil. He took the chance, in the purchase of the rights and in his expenditures for equipment and operation, of securing oil, either much or little. Whether after taking some out he had taken all did not alter the situation. A person who bought from him might by different drilling or drilling in a different place get a much larger quantity of oil than he had gotten—all dependent upon oil being found in place. The plaintiff did not purchase a certain number of barrels of oil stored in the earth; he

purchased a mere right to explore and bring to the surface and into his possession whatever oil he could find. This right was what he sold. It might have been actually more valuable or less valuable when he sold it than at the time of purchase. Whether there was oil
in place beneath the surface which could be reduced to posses-
16 sion was something that could not be known or determined,
and was dependent upon what movement the oil made from time to time under the surface.

The courts have decided that a person acquiring rights of this character does not acquire ownership of oil in place, and only owns it after he has reduced it to possession. He simply has a right to reduce to possession whatever oil he might find within the limits of the property. Ohio Oil Co. v. Indiana, 177 U. S. 190. Oil is transitory, with a tendency to disappear, it being there to-day and gone to-morrow. The fact that some oil has been extracted from the property does not affect the character of the right.

Oil has no fixed situs under a particular portion of the earth's surface within a given area. It has the power of self-transmission. It belongs to the owner of the land so long, and only so long, as it remains on it and subject to his control. It has been likened to animals ferae naturae, in that it has the power and tendency to escape without the volition of the owner, so that its existence within the limits of a particular tract is uncertain by reason of its fugitive and wandering tendency. It therefore follows that the property of the owner in oil rights is limited to the mere right to explore and attempt to reduce the oil to possession, and is not absolute until the oil is actually within his grasp and brought to the surface. Ohio Oil Co. v. Indiana, supra.

The claim by the Government of the right in fixing the net income of the plaintiff for taxation to deduct from the cost price of the property the amount of oil extracted is based upon a misconception of the character of this oil after it was extracted from the earth and reduced to possession. It went upon the theory that oil extracted was a part of the capital value of the property. It was, however, income and not capital return. Stratton's Independence, Ltd., v. Howbert, 231 U. S. 399. The defendant is attempting to tax it as a part of the capital return from the sale of this property. The current profits or income from business from year to year are to be accounted for in another form and do not enter into the capital return of the property, as contemplated by the statute, in arriving at a gain or loss by purchase and sale.

To remove the oil did not deplete the capital. For the foregoing reasons, the value of the oil taken out should not have been deducted from the original cost of the property in arriving at a gain or loss by the sale.

There is still to be considered the deduction made by the Government from the purchase price on account of depreciation. This depreciation was covered in the sale price. To deduct it from the cost or add it to the purchase price is equivalent to saying that,

while the sale price was $81,200, in fact it must be fancifully fixed at $91,200, and that, while $81,200 was the actual price received, it must be taken to have been $91,200. This depreciation was a part of the necessary wear and tear incident to the use of the property. It was an expense and incident to the business. To add it to the sale price or deduct it from the cost price is in effect to say that the property must be held to have remained in the same condition after use for a number of years that it was in at the time of purchase.

17 It follows that the Commissioner of Internal Revenue was also in error in deducting from the cost of the property the above amount for depreciation.

The parties in compliance with the order of the court remanding the case filed a supplemental stipulation containing some new facts, and stipulated that the amount of the judgment to be entered for the plaintiff, within the conclusion of the court as amended in this opinion, should be $10,893.45, with interest on $36.79 from June 15, 1918, and on $10,856.66 from November 9, 1923. It therefore becomes necessary to briefly discuss the facts, but before doing so some of the legal aspects of the case should be considered.

The sections of the revenue act of 1918, dealing with the questions propounded, are:

"Sec. 202 (a). That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

"(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

"(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203" (40 Stat. 1060).

"Sec. 213. That for the purpose of this title * * * the term 'gross income'—

"(a) Includes gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (40 Stat. 1065.)

In the case of Goodrich v. Edwards, 255 U. S. 527, the court held that the provisions of the act of September 8, 1916 (c. 463, 39 Stat. 756), as to taxable gain were in effect the same as those of the act of February 24, 1919 (c. 18, Title II, 40 Stat. 1057), and in United States v. Flannery, 268 U. S. 98, it was held that the provisions of the latter act "in reference to the gains derived and the losses sustained from the sale of property acquired before March 1, 1913, were correlative, and that whatever effect was intended to be given to the market value of property on that date in determining taxable gains,

a corresponding effect was intended to be given to such market value in determining deductible losses."

There are two decisions of the Supreme Court bearing upon the question before us, namely, Goodrich v. Edwards, supra, which was decided on March 28, 1921, and involved the provisions of the said act of 1916, supra, and the case of United States v. Flannery, ante, decided on April 13, 1925, and involving the said revenue act of 1918.

In the Goodrich case there were two transactions involved. The first had to do with certain shares of stock for which plaintiff paid $500. The market value of the stock on March 1, 1913, was $695, and he sold it in 1916 for $13,931.22. In the second case he purchased stock for $291,600, the value of which on March 1, 1913, was $148,635.50, and sold it in 1916 for $269,346.25. In the first of these transactions the court held that there was a taxable gain which was to be measured by the difference between the value of the
18 property as of March 1, 1913, and the sale price. In the
second, where the selling price was greater than the value of the property on March 1, 1913, but less than the cost thereof, there was no taxable gain or allowable loss. The decision of the lower court had been in favor of the Government in both of these transactions, holding that in the first the taxable gain was the difference between the value as of March 1, 1913, and the selling price, as the selling price showed a gain over the cost, and this was affirmed by the Supreme Court. In the second transaction the lower court held that the difference between the value as of March 1, 1913, and the selling price was a taxable gain. The Supreme Court, however, said this was error, as the difference between the cost price and the selling price showed no actual gain, and that as to this transaction there was neither gain nor loss. After the Goodrich case had been tried in the lower court and decided in favor of the Government, the Solicitor General, when the case came up for hearing in the Supreme Court, confessed error as to the judgment of the lower court in the second transaction, and the case was reversed as to this.

It appears in the opinion in the Flannery case, supra, that following the decision of the Supreme Court in the Goodrich case the Bureau of Internal Revenue revised its regulations and promulgated the following:

"ARTICLE 1561. BASIS FOR DETERMINING GAIN OR LOSS FROM SALE.—For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is the cost of such property, or if acquired on or after March 1, 1913, its cost or its approved inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain which is taxable is the excess of the amount realized therefor over such fair market value. Also in the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No gain or

loss is recognized in the case of property sold or exchanged (a) at more than cost but at less than its fair market value as of March 1, 1913, or (b) at less than cost but at more than its fair market value as of March 1, 1913. * * *."

This regulation contains provisions covering the following circumstances:

"(a) Taxable gain resulted if the selling price was higher than the value on March 1, 1913, and if that value was higher than the cost thereof, to the extent that the selling price exceeded the value on March 1, 1913;

"(b) No taxable gain or allowable loss resulted if the selling price was greater than the value of the property on March 1, 1913, but less than the cost thereof;

"(c) An allowable loss resulted if the selling price was less than the value on March 1, 1913, and if that value was less than the cost to the extent of the difference between the value on March 1, 1913, and the selling price;

"(d) No taxable gain or deductible loss resulted if the selling price was less than the value thereof on March 1, 1913, but greater than the cost."

19 This regulation of the Bureau of Internal Revenue is approved in the opinion of the Supreme Court in the Flannery case.

In the Flannery case the purchase price was less than $95,175; the value as of March 1, 1913, was $116,325, and the sale price was $95,175. The court held that there was neither taxable gain nor deductible loss, thus bringing the case under the above provision (d) of the regulation of the Bureau of Internal Revenue.

We now come to the case under consideration. The court has found that as to two of the properties involved, namely, the Goodman and Matney properties, which were purchased prior to March 1, 1913, the cost thereof was $20,000; the value as of March 1, 1913, was $47,500, and the selling price, $46,650. Thus the case presents the same question as to gain and loss as in the Flannery case, and, like it, comes within the provision of said regulation of the Bureau of Internal Revenue indicated as (d) in the foregoing analysis of that regulation. As to these properties, therefore, there was neither a gain nor a loss. As to the properties purchased subsequent to March 1, 1913, the facts found show that there was a loss of $7,927.33, and that, considering this loss, the correct taxable net income of the plaintiff for the year 1917 was $30,288.33 and the correct amount of tax due thereon, $2,073.36. The tax paid by plaintiff on June 15, 1918, for the year 1917 on the first assessment was $2,110.15 and on the second assessment, $10,856.66, paid on November 17, 1923, a total of $12,966.81, leaving a balance due the plaintiff of $10,893.45, with interest on $36.79 from June 15, 1918, to November 9, 1925, amounting to $16.33 (Finding IV), and on $10,856.66 from November 9, 1923, to November 9, 1925, amounting to $1,302.80, making a total for which judgment should be rendered of $12,212.58. The sum of

$36.79, for which interest is allowed above, is the difference between the first assessment ($2,110.15) paid by plaintiff and the amount which has been found to be correctly due ($2,073.36). Judgment should therefore be entered in favor of plaintiff in the sum of $12,212.58, and it is so ordered.

HAY, Judge; DOWNEY, Judge; BOOTH, Judge; and CAMPBELL, Chief Justice, concur.

20 V. *Judgment*

Nov. 9, 1925

At a Court of Claims held in the city of Washington on the 9th day of November, A. D. 1925, judgment was ordered to be entered as follows:

The court, upon due consideration of the premises, find in favor of the plaintiff, and do order and adjudge that the plaintiff, as aforesaid, shall have and recover of and from the United States the sum of twelve thousand two hundred and twelve dollars and fifty-eight cents ($12,212.58).

By the COURT.

21 [Clerk's certificate to foregoing papers omitted in printing.]

[Indorsed on cover:] File No. 31676. Court of Claims. Term No. 953. The United States, petitioner, vs. Charles A. Ludey. Petition for a writ of certiorari and exhibit thereto. Filed February 4, 1926. File No. 31676.

Supreme Court of the United States

Order allowing certiorari

Filed April 19, 1926

The petition herein for a writ of certiorari to the Court of Claims is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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INDEX

AUTHORITIES CITED

In the Supreme Court of the United States

October Term, 1925

No 953

The United States, petitioner

v.

Charles A. Ludey

BRIEF IN SUPPORT OF PETITION BY THE UNITED STATES FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

OPINION OF THE COURT OF CLAIMS

The opinion in this case has not yet been officially reported. The case was decided by the Court of Claims November 9, 1925, and the opinion of the court appears at pages 14 to 20 of the printed record.

JURISDICTION

Judgment of the Court of Claims was rendered November 9, 1925. (R. 20.) Petition for certiorari was filed February 4, 1926. (R. 20.) Jurisdiction to issue the writ is conferred upon the Court by Section 3 (b) of the Act of February 13, 1925 (chap. 229, 43 Stat. 936, 939).

THE QUESTION INVOLVED

In determining gain or loss of the owner or lessee upon the sale of capital assets under the tax laws, should depletion sustained or previously allowed for oil extracted and/or depreciation sustained or previously allowed be subtracted from the cost price in determining gain or loss upon sale in 1917?

STATEMENT OF THE CASE

This suit was to recover taxes paid under protest, and claimed to have been illegally assessed, and claim for refund of which had been denied. (R. 5-7.)

The findings of the Court of Claims show that respondent, Charles A. Ludey, filed a return of his income for the calendar year 1917. (R. 11.) In this return he claimed as a deduction from gross income an alleged loss upon the sale of certain oil properties, some of which were acquired before and some after March 1, 1913. (R. 11, 12.) The respondent contended in his petition in the court below that the loss was more than that claimed in his return, namely, $14,777.33. (R. 6.) The Commissioner of Internal Revenue found that respondent derived a taxable profit of $26,904.15 on such sales. (R. 14.)

The sale out of which the commissioner held that a gain arose was of certain oil property designated in the pleadings (R. 5, 6) as:

(1) The Goodman fee and Matney lease,

(2) The Wolfe lease,

(3) The Billingslea lease,

(4) The Pitman fee, and

(5) The Helphrey oil drilling rig.

Item No. 1, the Goodman fee and the Matney lease were purchased prior to March 1, 1913, at $20,000. They were worth on March 1, 1913, $47,500, and between March 1, 1913, and the date of sale, equipment and improvements had been added at a cost of $6,000. The remaining property, items Nos. 2, 3, 4, and 5 were acquired after March 1, 1913, at a total cost, including subsequent improvements, of $42,477.33. The entire property was sold in 1917 for $81,200. Between March 1, 1913, and the date of sale these properties had been operated by the respondent and certain oil had been extracted. (R. 11, 12.) The value of the oil thus extracted was $32,253.81. During the same period the equipment had been used by the respondent and had depreciated by wear and tear to the extent of $10,465.16. (R. 12.) In calculating the gain derived from this transaction the Commissioner of Internal Revenue determined that the decrease by reason of the depletion of the oil reserves and the depreciation from wear and tear should be deducted from the cost of the property sold before determining whether there was a gain. (R. 12.) The respondent in arriving at a loss from this transaction deducts nothing for the depletion of the oil reserves and nothing for the wear and tear of the equipment. (R. 8.)

The Court of Claims held that the Government's depletion and depreciation adjustments on sale of property in 1917 were erroneous.

THE STATUTES

Title I, Act of September 8, 1916 (chap. 463, 39 Stat. 756), as amended by the Act of October 3, 1917 (chap. 63, 40 Stat. 300, 329), provides:

> SEC. 1. (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *.
>
> (b) In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a nonresident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceeds $20,000 and does not exceed $40,000 * * *.
>
> (c) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.

SEC. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * *.

* * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

* * * * *

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or

other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: *Provided,* That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *.

SEC. 1. WAR INCOME TAX (chap. 63, 40 Stat. 300).—That in addition to the normal tax imposed by subdivision (a) of section one of the Act entitled "An Act to increase the revenue, and for other purposes," approved September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like normal tax of two per centum upon the income of every individual, a citizen or resident of the United States, received in the calendar year nineteen hundred and seventeen and every calendar year thereafter.

SEC. 2. WAR INCOME TAX.—That in addition to the additional tax imposed by subdivision (b) of section one of such Act of September eighth, nineteen hundred and sixteen, there shall be levied, assessed, collected, and paid a like additional tax upon the in-

> come of every individual received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, as follows:
>
> One per centum per annum upon the amount by which the total net income exceeds $5,000 and does not exceed $7,500 * * *.

Title II, Act of October 3, 1917 (chap. 63, 40 Stat. 303), provides:

> SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:
>
> Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year * * *.

ARGUMENT

I

THE SALE OF THE CAPITAL ASSETS HEREIN DID NOT RESULT IN AN ACTUAL LOSS DEDUCTIBLE FROM GROSS INCOME FOR THE PURPOSE OF DETERMINING NET INCOME UNDER THE PROVISIONS OF THE REVENUE ACT OF 1916 AS AMENDED

The first question presented by the decision of the Court of Claims is whether the sale of certain

capital assets resulted in an *actual* loss deductible from gross income for the purpose of determining net income under the provisions of the Revenue Act of 1916 as amended.

That statute permits the deduction of "losses actually sustained during the year, incurred in his business or trade * * *." The loss allowed by the Court of Claims arose out of the following transaction. On March 1, 1913, the taxpayer had a capital asset consisting of the Goodman Fee and the Matney Lease and the physical equipment thereon worth $47,500. Thereafter he acquired certain other properties and made certain improvements at a total cost of $48,477.33. By this outlay he acquired a right which the court below describes as "a mere right to extract whatever oil he could, be that amount small or great." During the period of his ownership, the taxpayer exercised his right and removed oil which, in the ground, had a value of $32,253.81. During the year 1917, he sold the properties for $81,400.00. The total outlay therefore was $95,977.33 as against total receipts of $113,653.81. It is plain that this transaction did not cause the taxpayer any *actual* loss. To demonstrate this, it is only necessary to assume that, instead of taking a *part* of the available oil, the taxpayer had taken it *all,* and had then sold the properties for a nominal sum. It could not be contended that, under such circumstances, the mere fact that the price obtained was less than the price

paid, showed that the taxpayer had *actually* sustained a loss.

II

A TAXABLE GAIN RESULTED HEREIN BY THE SALE OF THE CAPITAL ASSETS

The second question involved is whether there is a taxable gain. In determining the gain, the Commissioner of Internal Revenue deducted the amount of depreciation ($10,465.16) and of depletion ($32,253.81), sustained since March 1, 1913, from the cost (or value) of the properties sold, and thus ascertained that the properties sold represented a capital investment of $53,258.36 at the time of the sale. The difference between this amount and the sale price ($81,200.00), being the increase in the value of the assets sold, and thus gain realized, was included in the taxpayer's gross income.

It is clear that in the operation of an oil property, the whole gain is derived from the removal and sale of oil and the increment in the value of the oil remaining in the ground or in the right to remove it. This increment depends upon factors collateral to the right, among others the demand for oil. As this demand increases, the value of the right increases. Consequently, when it becomes necessary to ascertain whether or not a gain has been derived from the sale of an oil property, it is necessary to ascertain what, if any, increment in value is included in the sale price. This increment

is reflected in the price per barrel of daily production, upon which basis oil properties are bought and sold. For example, if a well producing ten barrels is bought in 1913, its price might be $10,000.00, which is another way of saying that that property is expected to produce ten barrels of oil per day for one thousand days, oil being worth "in the ground" one dollar per barrel. If this property later is sold at $1,500.00 per barrel of daily production, and if the daily poduction is still ten barrels, then it is manifest that, since the expected productive life is shorter, the value per barrel in the ground has increased. This increase is realized when the right to remove and sell the oil is sold, and such sale results in a taxable gain. Accordingly, it is the practice, not only of the Bureau of Internal Revenue, but also of dealers in oil property, to deduct from the cost of the property, the value in the ground of the oil removed, in order to ascertain the increment in the value of the remaining oil.

The Court of Claims holds that the plaintiff sold exactly the same property which he bought, namely, the right to remove oil and that, since the oil recovered during his ownership was income and not a return of capital, no deduction from cost price should be made for the purpose of ascertaining gain. It is urged that the taxpayer has *not* sold the same right which he acquired. This is necessarily true because in the meantime the taxpayer has used that right. Whether or not this use has produced income is immaterial. The fact

that the use changed the character of the property is the material factor. The cost of the property is merely the ***basis*** for determining gain or loss. Further steps are necessary in such determination, one of which is the comparison of the ***property sold*** with the ***property bought***. These properties must be identical, for it is the cost of the property sold which is the basis for determining the gain derived from the sale. If, after the property is acquired, its character has for any reason been changed, then, while it may be possible that the taxpayer is entitled to a deduction from income by reason of such change, he is not entitled to compare the cost of the unchanged property with the sale price of the changed property for the purpose of determining whether a gain has been made. The distinction is this: If the taxpayer had, without removing any oil, sold his right for a less sum than it cost him, he would have sustained a loss because the decrease in value would have been due to economic causes, such, for instance, as an error in the estimate of the oil reserve at the time the taxpayer acquired it, or a decrease in the value of the oil in the ground. But to the extent that the decrease in value is due to the removal of oil, it is not due to economic causes, but to changes, in the nature of the property acquired, after such acquisition but prior to the sale of the property.

The Court of Claims answers this contention by pointing out that the respondent did not purchase a certain number of barrels of oils stored in the earth.

The court states " he purchased a mere right to explore and bring to the surface and into his possession whatever oil he could find." Theoretically, that statement is correct, but as a practical matter, the right which was purchased was an *oil reserve* which was susceptible of approximate measurement so that at least the price which the respondent paid for the right to remove the oil was based upon the number of barrels estimated to be in the reserve. Likewise, when he sold, the price he received was based upon the number of barrels estimated to be in the reserve at the time of the sale. The respondent's theoretical right was " exhausted " by the removal of the oil. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. So that it is quite inaccurate, as a practical matter, to say that the right which the respondent sold was the same as the right which he purchased.

III

THE EFFECT OF THE DECISION OF THE COURT OF CLAIMS IS TO PERMIT A DEDUCTION FROM THE SALE PRICE OF AN AMOUNT PREVIOUSLY DEDUCTED BY WAY OF DEPRECIATION AND DEPLETION FROM CAPITAL INVESTMENT IN PRIOR YEARS

Even if the decision of the Court of Claims is sound in regard to depletion and depreciation sustained but not allowed as a deduction in previous years, it would seem quite apparent that the cost of the properties should be reduced to the extent that depletion and depreciation were actually allowed

and deducted by the taxpayer in his previous returns. As this Court said in *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, it is entirely immaterial whether the capital expended in the production of income be returned by way of a depreciation allowance or by deducting the cost from the purchase price. Certainly the statute does not contemplate that both deductions shall be taken. *Nashville, C. & St. L. Ry. Co.* v. *United States*, 269 Fed. 351. (Certiorari denied 255 U. S. 569.) Yet to the extent that the depreciation and depletion have been allowed and deducted in prior years, the result of the decision of the Court of Claims is that the taxpayer, having deducted a part of the capital investment by way of depreciation and depletion allowances in prior years, is permitted to deduct it again from the price obtained. The findings of fact show that depletion and depreciation were deducted in the amount of \$5,156.00 (R. 12) so that the loss on the sales, on this basis, was approximately \$2,800.00 instead of \$7,900.00.

The Court of Claims says that the depreciation was covered in the sale price. By this it is understood that the court means that the property sold brought less money because of its depreciated condition. One of the factors which entered into the sale price was the depreciation of the property. Another factor was the increment in the value of the property. In other words, the depreciated property would have been worth less at the time

that the taxpayer acquired it than was the depreciated property at the time it was sold. The value of the property new, as it was at the time it was acquired, should not be deducted from the value of the property in its condition when sold, to determine gain or loss, because, while the depreciation was " covered in the sale price," it was not " covered in the cost."

CONCLUSION

The importance of this case has been pointed out in the petition for certiorari. (R. 4.) The rule followed by the Government has been approved by the Board of Tax Appeals in the case of *Even Realty Company*, 1 B. T. A. 355. It may be added that the principle involved, namely, that in ascertaining the gain or loss from the sale or other disposition of capital assets, it is necessary to adjust the cost or March 1, 1913, value with reference to depletion and depreciation allowed and sustained, as well as with reference to improvements and betterments, has been applied by the Bureau of Internal Revenue without exception. Consequently, it would be necessary to reaudit all returns which include either a gain or a loss from the sale or other disposition of capital assets if the Court of Claims decision were followed.

In view of the reasons herein set out, it is felt that this case presents a matter of importance not only to the Government in respect to its revenues, but also to the public at large, many of whom at

some time or other report an income from the sale or other disposition of capital assets. Your petitioner therefore prays for a writ of certorari directing the Court of Claims to certify the record herein to this Court in order that the issues involved therein and the determination of the Court of Claims may be reviewed.

Respectfully submitted.

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